

SURREBUTTAL TESTIMONY OF TIMOTHY DOMINAK

I. Introduction

Q. Please state your name and business address.

A. Timothy Dominak, 2000 West Ameritech Center Drive, Hoffman Estates, IL 60196.

Q. Are you the same Timothy Dominak who previously submitted Ameritech Illinois Exhibit 7.0 and 7.1 Schedules 1, 2, and 3 in this docket?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my testimony is to respond to portions of the Rebuttal Testimony of certain witnesses for the Staff and the Government and Consumer Intervenors ("GCI") in which they propose adjustments to the 1999 operating income statement and December 31, 1999 statement of Net Original Cost of Property, as shown in Schedules 1 and 2, respectively, of my Rebuttal Testimony, Exhibit 7.1.

Q. Have you updated your Schedules to reflect more current information?

A. Yes. Schedules 1 and 2 of Ameritech Illinois Exhibit 7.1 should be adjusted to reflect adjustments proposed by Staff and GCI that the Company agrees should be reflected in the Company's financial results for 1999. These adjustments are discussed in Section II of this Surrebuttal Testimony. The adjustments discussed in Section II are reflected in the revised statements of operating income and net original cost of property contained in Schedules 1 and 2, respectively, attached to this Surrebuttal Testimony.

II. REBUTTAL ADJUSTMENTS WHICH THE COMPANY ACCEPTS FOR REGULATORY FINANCIAL REPORTING PURPOSES.

Q. Are there any adjustments proposed by Staff and GCI in Rebuttal Testimony in this case which the Company accepts?

Yes, the Company accepts certain proposed adjustments for the following items:

- (1) Uncollectibles
- (2) Gross Receipts Tax
- (3) Accumulated Deferred Income Taxes
- (4) SOP 98-1 Software Capitalization

Q. Staff witness Voss and GCI witness Smith propose an adjustment for the calculation of uncollectible expense to the Ameritech Illinois update of “Intrastate Known Changes” for 2000 Tariff Filings on Exhibit 7.1, Schedule 1 Column F. Please discuss this adjustment.

A. As I indicated in my Rebuttal Testimony, the Company has accepted Mr. Voss’ proposed uncollectible rate of 1.67%, as calculated on page 2 of Staff Exhibit 5.0.

It is appropriate to use this rate for calculating the effect on uncollectible expense of the adjustment to revenue to reflect the additional 2000 Tariff Filings, presented on Ameritech Illinois Exhibit 7.1, Schedule 1, Column F. Accordingly I have reflected the impact of this adjustment on Exhibit 7.2, Schedule 1, Column

B. This adjustment increases the balance available for return by \$.141 million.

Q. At pages 10-12 of his Rebuttal Testimony, Mr. Voss discusses his proposed adjustments for gross receipts taxes (Staff Ex. 19.0, Schedule 19.07). Do you have any comments in response to Mr. Voss’ testimony in this regard?

A. Yes. Mr. Voss has clarified and modified the proposed adjustment as it was originally presented in his Direct Testimony, to remove an equal amount from both revenue and expense. The Company accepts Mr. Voss’ modified adjustment,

which I have reflected on Exhibit 7.2, Schedule 1, Column C. This adjustment does not impact the balance available for return.

Q. GCI witness Smith proposed an intrastate adjustment of \$19 million to reflect Accumulated Deferred Income Taxes (ADIT) for Uncollectibles in Schedule E-17 of GCI Exhibit 6.3. Please discuss this adjustment.

A. I agree with the premise of Mr. Smith's proposal to adjust ADIT for the Uncollectibles that have been previously reflected in Ameritech Exhibit 7.1, Schedule 1, Column L. However, his calculation is incorrect. As shown in Column L of Schedule 1 of Ameritech Illinois Exhibit 7.1, the uncollectible expense adjustment was \$18.685 million. It is only the tax effect of the Company accepted adjustment from Exhibit 7.1, Schedule 1, Column L that would impact the ADIT balance. Accordingly, I have properly reflected this adjustment of \$7.412 million on Exhibit 7.2, Schedule 2, Column B.

Q. At pages 11 to 12 of his Rebuttal Testimony, Mr. Smith proposes a revised expense adjustment for software capitalization pursuant to SOP 98-1. Does the Company agree with Mr. Smith's proposed revision?

A. Yes. The adjustment which Mr. Smith initially proposed, and the Company accepted, was to reduce Plant Specific Operations expense by \$1.319 million. I agree with Mr. Smith that the correct adjustment should be \$1.306 million. An adjustment to make this correction is reflected in Exhibit 7.2, Schedule 1, Column D. This adjustment increases the balance available for return by \$.008 million.

Q. Please Describe Schedule 1 of Ameritech Illinois Exhibit 7.2.

A. Schedule 1 of Exhibit 7.2 is a revision of Schedule 1 of my Exhibit 7.1. Column A is equal to Column M of Exhibit 7.1.

Column B contains the intrastate Uncollectible adjustment to year 2000 Tariff

Filings proposed by Mr. Voss and Mr. Smith.

Column C contains the gross receipts tax adjustment proposed by Mr. Voss.

Column D contains the adjustment for the application of the intrastate allocation factor for Plant Specific Operations related to the SOP 98-1 adjustment proposed by Mr. Smith.

Column E reflects the Adjusted Intrastate Operating Results and is the sum of Column A through column D.

Column F contains the AFUDC revenue requirement offset discussed later in my testimony.

Column G contains the adjustment for the correct nonregulated factor related to the merger cost adjustments discussed later in this testimony.

Column H reflects the Total Intrastate Balance Available for Return and is the sum of E through G.

Q. Please describe Schedule 2 of Ameritech Illinois Exhibit 7.2.

- A. Schedule 2 of Exhibit 7.2 is a revision of Schedule 2 of my Exhibit 7.1. Column A is equal to Column D of Exhibit 7.1. Column D includes other adjustments addressed by Staff and GCI that the Company considers to be appropriate. Column B contains the adjustment of ADIT for uncollectible expense previously reflected on Schedule 7.1, Schedule 1, Column L. Column C contains the Company adjustment to Telephone Plant Under Construction and the corresponding offset to Telephone Phone In Service.

Column D reflects the Total Intrastate Net Original Cost and is the sum of
Columns A through C.

**III. ADJUSTMENTS WHICH THE COMPANY BELIEVES ARE NOT
APPROPRIATE FOR REGULATORY FINANCIAL REPORTING**

A. Interest Synchronization

Q. Mr. Voss and Mr. Smith continue to argue that an adjustment should be made to synchronize Ameritech Illinois' interest expense for purposes of calculating 1999 income tax expense. Do you agree with this adjustment?

A. No. For all the reasons discussed in my Rebuttal Testimony, an interest synchronization adjustment is inappropriate in the context of this proceeding. The adjustment understates actual interest expense the Company incurred in 1999 and, therefore, overstates the Company's earnings.

B. Depreciation and Amortization Expense

Q. Have you reviewed the testimony on depreciation presented by Staff Witness Green in his Rebuttal Testimony, Staff Exhibit 24.0 and GCI Witness Dunkel in GCI Exhibit 9.0?

A. Yes. Mr. Green has proposed an adjustment of \$60.445 million to reflect what he asserts is a correct jurisdictional allocation of depreciation expense. I will discuss Mr. Green's adjustment below. The depreciation adjustments proposed by Mr. Dunkel, including adjustments related to the Company's amortization of FAS 71 and rates reflecting service lives, net values, and curve shapes developed by the FCC, should not be adopted for the reasons addressed by Mr. Gebhardt.

Q. Mr. Green and Mr. Dunkel testify that depreciation expenses are to be separated on the basis of their primary accounts and related categories in compliance with C.F.R. 36.361, Jurisdictional Separations. Do you agree?

A. Yes. In fact, the Company adheres to this requirement. The Company calculated the intrastate amounts of depreciation expense by subtracting nonregulated and

interstate amounts from the total Company amounts. This procedure is equivalent to calculating intrastate amounts by subtracting nonregulated and then applying intrastate factors to the subject to separations amounts because the sum of the interstate and intrastate factors must equal 1. Accordingly, Mr. Dunkel's assertion that the Company violated the FCC's jurisdictional separations procedure is incorrect.

Q. Do you have any comments regarding Mr. Green's proposed adjustment of \$60.445 million.

A. Yes. Mr. Green made some errors in the calculation of his adjustment. Mr. Green first calculated intrastate amounts and then estimated a jurisdictional nonregulated amount. The correct procedure is to subtract total nonregulated from total company, derive a subject-to-separations amount, and then jurisdictionally separate the amounts. This process has been in place since 1987 at the conclusion of the Joint Cost proceeding (See In the Matter of Separation of costs of regulated telephone service from costs of nonregulated activities, CC Docket No. 86-111, Report and Order, Released February 6, 1987, at Paragraph 116).

Q. Has the process used by the Company, i.e. subtract total nonregulated from total company amounts, been adopted by this Commission ?

A. Yes. (See Title 83: Public Utilities, Part 711, Cost Allocation for Large Local Exchange Carriers).

Q. Mr. Green indicated that he performed the jurisdictional separations by depreciable Uniform System of Account (USOA). Mr. Dunkel implies he likewise performed the jurisdictional separations by depreciable USOA account. Does the Company's proposed adjustment jurisdictionally separate by USOA account?

A. No, the Company's proposed adjustment was by primary plant account or related account pursuant to C.F.R. Part 36, Jurisdictional Separations Rules which do not require separations by depreciable USOA account. For example, for Central Office Expenses, the Part 36 rules require that the expenses be apportioned on the basis of Central Office Switching, Account 2210, Operator Systems, Account 2220, and Central Office Transmission, Account 2230, combined (See C.F.R. Part 36.321). There are similar Part 36 requirements for the other categories of expenses.

Q. Do the errors made by Mr. Green account for the entire amount of his adjustment?

A. No. The Company is continuing to investigate the reasons which account for the difference between the Company's proposed level of depreciation expense of \$666.108 million and the amount calculated by Mr. Green of \$666.108 million. As of this writing, the Company has not received responses from Staff to data requests directed to Mr. Green's rebuttal testimony, including a request for workpapers used in the preparation of Schedule 24.1 of Staff Exhibit 24.0. Ameritech Illinois reserves the right to present additional testimony after it has had an opportunity to complete its review.

Q. Mr. Dunkel maintains that Ameritech included \$124.9 million of intrastate depreciation expense for the three accounts that you said you corrected for in your Rebuttal Testimony. Is Mr. Dunkel correct ?

A. No. The Company included \$101.656 million of intrastate depreciation expense for Analog Switching, Account 2211, General Purpose Computers, Account 2124, and Circuit DDS, Account 2232.11 in my direct testimony and made an adjustment to remove that amount in my surrebuttal testimony, as shown on my

Exhibit 7.1, Schedule 1. The Company provided supporting documentation for this adjustment in response to Cook County Data Request number 236. A copy of that response is attached to Attachment A. Staff Witness Green agrees with the Company adjustment.

Q. Mr. Dunkel proposes an adjustment of \$42.3 million to eliminate double counting from the Company's failure to eliminate \$124.9 million for the three accounts described above. Is this an appropriate adjustment ?

A. No. The Company made the proper adjustment as described above. As a result, there is no double counting to be adjusted for.

Q. Mr. Dunkel proposes an adjustment of \$11.2 million to remove the amortization for Analog Circuit Equipment. Mr. Dunkel claims there is no evidence that the Commission authorized this amortization and even if there were authorization, it should not be used for setting rates for the future. Please comment.

A. The Company's response to City of Chicago Data Request 126 included Staff Exhibit 7.01 in Docket 92-0448 which showed the authorized amortization of \$11.2 million. This is corroborated by Mr. Dunkel's Rebuttal Testimony at Page 48 which describes the authorization in Ms. Marshall's testimony. Further, the Commission explicitly allowed this amortization (See Docket 92-0448/93-0239 at Page 150). Since the amortization is a Company expense, it should be included in the Company's reported financial results.

Q. Mr. Dunkel proposes an adjustment of \$32.1 million for other amortizations. Please comment.

A. As explained by Mr. Gebhardt, the Company adopted more realistic depreciation rates in addition to amortizing the FAS 71 adjustment to better conform its depreciation rates with those used for external financial reporting purposes. Mr. Dunkel's proposed adjustment negates the Company's adoption of more realistic

depreciation rates and should not be adopted for all the reasons described by Mr. Gebhardt.

C. 1999 Pension Settlement Gains

- Q. At pages 2 through 4 of her Rebuttal Testimony, Staff witness Hathhorn discusses her proposed adjustment for pension settlement gains. Do you have any comments in response to Ms. Hathhorn's proposal?**
- A. Yes. As in her Direct Testimony, Ms. Hathhorn proposes an adjustment to amortize over five years the amount by which the Company's \$66.189 million intrastate pension gain exceeds what she claims to be a normal level of such gains. The effect of her adjustment is to reduce Corporate Operations Expense for 1999 by the amount of \$16.855 million, as shown on Staff Exhibit 20.0, Schedule 20.01, page 2. Ms. Hathhorn also proposes to make a similar adjustment, in the amount of \$6.795 million, for Ameritech Illinois' allocable share of the 1999 net pension settlement gains charged to Ameritech Services, Inc. ("ASI"). See Staff Exhibit 20.0, Schedule 20.01, page 3. As a result, the total amount of Staff's proposed adjustment for pension settlement gains is \$23.650 million. For the reasons which I discussed in my Rebuttal Testimony, all of the pension settlement gains at issue represent an accelerated recognition of gains that occurred in prior periods, but were deferred in accordance with FAS 87 accounting rules. Thus, as Ms. Hathhorn expressly acknowledges (Staff Exhibit 20.0, page 3), it is not appropriate to consider the pension settlement gains as a current period (1999) gain. Ms. Hathhorn contends that there is more than one option in achieving this result. Ms. Hathhorn, however, provides only one option, and that is inclusion of a level of pension settlement gains for the 1999 period based on a review of prior

periods. This option, which is based on gains and losses that occurred in prior periods, should be rejected. As I discussed in my Rebuttal Testimony, it is not appropriate to recognize pension settlement gains for purposes of defining a normalized year of financial data. Ms. Hathhorn's proposed adjustments should, therefore, be rejected.

Q. At page 3 of her testimony, Ms. Hathhorn asserts that it is "appropriate to adjust the 1999 gains down to a normal level." Do you have any response to Ms. Hathhorn's assertion?

A. Yes. For the reasons previously discussed, it is not appropriate to reflect any portion of pension settlement gains in the 1999 operating income statement for purposes of this proceeding. I would further note, however, that Ms. Hathhorn's adjustment overstates the "normal level" of pension settlement gains.

Q. Please explain how Ms. Hathhorn's adjustment overstates the "normal" level of pension settlement gains.

A. Ms. Hathhorn refers to an analysis of historical data which shows that, for the period from 1991 through 1998, the average annual pension settlement gain recorded by Ameritech Illinois was \$5.010 million per year and Ameritech Illinois' average allocable share of Ameritech Services' pension settlement gain was \$4.560 million. [Staff Exhibit 20.0, Schedule 20.01, page 4.] The regulated, intrastate portions of those pension settlement gain amounts are \$3.712 million and \$3.379 million, respectively. These are the pension settlement gain levels considered to be "normal." Ms. Hathhorn, however, has added to these amounts a five year amortization of the amounts by which the abnormally high level of pension settlement gains experienced in 1999 exceeded the "normal" levels. As a

result, the Staff adjustment of \$23.650 million exceeds by over \$16.56 million the “normal” level of annual pension settlement gains.

Q. Please explain why the levels of pension settlement gains recorded in 1999 by Ameritech Illinois and ASI were abnormally high.

A. The pension settlement gains were unusually high due to the large number of retirements of both management and non-management personnel that elected to receive their pension in a lump sum payment.

Q. GCI witness Smith disputes your contention that it is inappropriate to consider the pension settlement gains as a current period expense. Mr. Smith maintains these amounts are recorded on IBT’s books pursuant to FAS 87 and FAS 88 for both regulatory accounting and financial reporting purposes as current period expense and that the amount recorded in 1999 is a current period expense for 1999. Do you have any comments?

A. Yes. FAS 87 accounting requires various cost components, such as the expected return on plan assets, to be amortized over the average service life of the covered employees and are therefore unrecognized in the accounts in the financial statements until future years. For example, if the expected investment return is assumed to earn 7% per year and the actual return for the period is 15%, an actuarial gain has occurred. Substantial expense fluctuations would occur if every time large changes in the market value of plan assets or actuarial assumptions, i.e., mortality rates, employee turnover, future salaries were recognized immediately. Therefore, various smoothing techniques allow these gains or losses to be recognized over time which decreases the expense volatility.

When a large amount of people retire and elect a lump sum pension payment, all assumptions are now known and are final. Essentially, the pension settlement is the receipt of the lump sum cash payment by the plan participant in exchange for

relieving the employer of the responsibility for the pension benefit obligation and the associated risks related to it. Therefore, since the employer is relieved of the liability, financial standards require the recognition of this event to be recognized in the current period. However, the gains that are recognized in this instance are primarily related to favorable market returns with respect to the plan assets that occurred prior to 1999, but have now been recognized as expense credits. It would not be appropriate to include this large credit amount as a current period operating expense level in this proceeding.

Q. Mr. Smith alleges that for the “first half of 2000 alone IBT has recorded approximately \$98 million additional pension settlement gains” which, according to Mr. Smith, shows that the “pension settlement gains IBT recorded in 1999 were not a one-time occurrence.” [GCI Exhibit 6.2, page 27.] Do you agree with Mr. Smith?

A. No. The large amount of pension settlement gains recorded during the first half of 2000 reflects a carryover effect of the same unusual set of circumstances which led to an abnormal amount of pension settlement gains in 1999. These settlement gains are attributable to personnel who elected to retire in 1999, but did not receive the lump sum cash payout from the pension plan until 2000. It is the payment year that triggers recognition of the special pension settlement accounting even though the retirements occurred in 1999. Additionally, once the threshold of significant pension payouts is exceeded in a given year, all lump sum payments for the year must be recognized under the settlement accounting. Since the significant amount of retirement payouts which generated the pension settlement gains experienced in the 1999-2000 time frame represent an abnormal “one-time” occurrence.

Q. Do you have any comments on the proposals of Ms. Hathhorn and Mr. Smith to use a five year period for amortizing the abnormal level of pension settlement gains experienced in 1999?

A. Yes. For the reasons I have discussed, the level of pension settlement gains experienced in 1999 represents a non-recurring, prior period event and, therefore, should be eliminated entirely in presenting a normalized 1999 operating income statement. Moreover, the use of a five year amortization period is arbitrary. If an amortized level of pension settlement gains were to be reflected in the 1999 data, the appropriate amortization period would be 11.4 years for management and 16 years for non-management employees. This represents the average future working lifetime calculation from the most recent actuarial valuations and is used to amortize the deferred pension plan unrecognized gains and losses.

Q. Ms. Hathhorn (page 4) asserts that “[n]either the revenue requirement in [Docket Nos. 92-0448/93-0239 (Consol.)], nor the inputs for the price cap formula used today, contain any factors or adjustments to exclude pension expense from the cost of service to ratepayers.” Do you have any comments in response to Ms. Hathhorn’s assertion?

A. Yes. As Ms. Hathhorn (page 4) recognizes, the revenue requirement used to establish the “going-in” rates approved in the original Alternative Regulation Order (“Alt Reg Order”) (Docket Nos. 92-0448/93-0239 (Consol.)) did not contain an allowance for pension expense. Contrary to Ms. Hathhorn’s assertion, therefore, the revenue requirement adopted in Docket Nos. 92-0448/93-0239 (Consol.) did, in fact, “exclude pension expense from the cost of service” recovered through the rates established in that proceeding. Ms. Hathhorn’s further assertion that the price cap formula does not contain any factors which exclude pension expense is meaningless because the price cap formula also does

not include any factors which include pension expense (or any other specific expense item). As I indicated in my Rebuttal Testimony, as a result of the price cap formula adopted in Docket Nos. 92-0448/93-0239 (Consol.), the overall rates charged for non-competitive service (which reflected no allowance for pension expense) declined every year since issuance of the Alt Reg Order. Accordingly, there is no basis for the suggestion made by Ms. Hathhorn in direct testimony that ratepayers have been paying for pension expense since the issuance of the Alternative Regulation Order, and, therefore, no basis for her assertion that ratepayers “deserve full recovery of any benefit of any gains reflected in the Company’s pension fund.” I would also note that the Company’s 1999 operating income statement reflects negative pension expense (even without recognition of the pension settlement gains). Accordingly, any “revenue requirement” established in this case would include no allowance for pension expense.

Q. Mr. Smith asserts that if the test year in Docket Nos. 92-0448/93-0239 (Consol.) reflected a credit of \$37.7 million for pension expense, consistent treatment in this proceeding would be to leave the 1999 pension settlement gains of \$98.6 million in Ameritech Illinois’ 1999 operating results. Do you agree with Mr. Smith’s reasoning?

A. No. Mr. Smith incorrectly assumes that the credit of \$37.7 million for negative pension expense in Docket Nos. 92-0448/93-0239 (Consol.) represented pension settlement gains. This is not the case. In fact, only \$4.9 million represented net settlement gains, most of which was attributable to a voluntary early retirement program. The inclusion of such a small part of the settlement gain in 1992 does not justify the inclusion of the abnormal amount of \$98.6 million of 1999

settlement gains, which are not related to a “voluntary retirement program,” in the Company’s expenses for this proceeding.

Q. Do you have any additional comments regarding Mr. Smith’s recommendation that the intrastate portion of the \$98.6 million of pension settlement gains recorded by Ameritech Illinois be amortized over a five year period?

A. Yes. His recommendations should be rejected for the reasons discussed above and in my rebuttal testimony. In addition, it should be noted that the calculation of the adjustment for pension settlement gains, shown on Schedule E-3 of GCI Exhibit 6.3, does not accurately reflect Mr. Smith’s proposal to amortize pension settlement gains over five years. As indicated on Schedule E-3, the intrastate portion of \$98.6 million is \$66.189 million. To reflect removal of the entire amount of this gain (which is recorded as a credit) from 1999, the Company made an adjustment to increase corporate operations expense by \$66.189 million. To properly reflect amortization of this amount over a five year period (rather than a complete removal of the credit, as proposed by the Company), an adjustment would need to be made to add back as a credit (thereby reducing expenses) an amount equal to $\frac{1}{5}$ of \$66.189 million, or \$13.238 million. The adjustment shown on Schedule E-3 of GCI Exhibit 6.3, however, reduces the Company’s proposed level of 1999 corporate operations expense by \$52.951 million, thereby effectively adding back a credit equal to $\frac{4}{5}$ of the 1999 intrastate pension settlement gain of \$66.189 million. The Company has been informed by GCI that Mr. Smith intends to make a correction to Schedule E-3 to reflect a five year amortization.

Q. At page 14 of his Rebuttal Testimony, Mr. Smith discusses his proposal to amortize the Ameritech Services 1999 pension settlement gains over five years. Do you agree with Mr. Smith's proposal?

A. No. Mr. Smith's proposal should be rejected for the reasons I have previously discussed. In addition, Schedule E-15 of GCI Exhibit 6.3 reflects an adjustment to reduce the Company's proposed level of expenses by \$14.829 million, equal to 4/5 of the intrastate portion of Ameritech Illinois' allocable share of ASI's 1999 pension settlement gains. The effect of this adjustment is to include in Mr. Smith's proposed 1999 test year revenue requirement a credit for ASI's pension settlement gains of \$14.829 million. If the gains were amortized over five years, the amount of the credit included in the 1999 year revenue requirement would be \$3.707 million ($1/5 \times \18.536 million), not \$14.829 million. The Company has been informed that Mr. Smith intends to correct this additional adjustment shown on Schedule E-15.

Q. At pages 28-29 of his Rebuttal Testimony, Mr. Smith continues to argue that the abnormal level of pension settlement gains experienced in 1999 are related to the SBC/Ameritech merger. Do you have any response to Mr. Smith's testimony in this regard?

A. Yes. The total lump sum pension payments made during 1999 from the Ameritech qualified pension plans to participants who were terminated as a result of the SBC/Ameritech merger was \$10.3 million, of which only \$1.2 million relates to Ameritech Illinois employees. This amount of payments alone did not exceed the annual threshold and therefore did not trigger settlement accounting. Therefore, Mr. Smith's assertion that some of the 1999 pension settlement gains are related to the Ameritech merger is simply without merit.

- Q. Assuming that the pension settlement gains realized in 1999 were attributable to the SBC/Ameritech merger, would that fact justify Mr. Smith's proposed adjustment?**
- A. No. To the contrary, if the 1999 pension settlement gains were attributable to the merger (and they are not), that fact would provide an additional reason to exclude any recognition of the gains from a calculation of the Company's "revenue requirements" in this proceeding. Merger-related costs and savings are appropriately addressed in the Commission mandated tracking of such costs and savings. Furthermore, the Commission has ruled that shareholders of Ameritech Illinois are entitled to 50% of the benefit of net merger-related savings with 50% to be shared with customers.
- D. Pension Settlement Gains - 2000**
- Q. At page 22 of his Rebuttal Testimony, Mr. Smith proposes an adjustment to "amortize, over a five year period, the impact of known pension settlement gain recorded by IBT in 2000." Is there any justification for this proposed adjustment?**
- A. Absolutely not. Mr. Smith is proposing to make this adjustment in addition to (not in lieu of) his adjustment to include pension settlement gains recorded in 1999. There is no valid reason to include in the 1999 operating income statement pension gains recorded in the year 2000. In this regard, Mr. Smith does not purport to justify his adjustment (and there would be no basis to justify his adjustment) as necessary to reflect a known and measurable change in the level of a 1999 expense or revenue item. To the contrary, Mr. Smith is attempting to "double-count" an income statement item by including adjustments for both the 1999 and 2000 pension settlement gains credits.

Q. Mr. Dominak, does Staff agree with your conclusion that year 2000 pension settlement gains should not be used to adjust the 1999 expenses?

A. Yes. Ms. Hathhorn acknowledges on page 4 of her surrebuttal testimony that it is inappropriate to bring year 2000 actual pension settlement known data into the adjustment of the 1999 expenses.

E. TPUC and AFUDC

Q. Do you agree with Ms. Hathhorn's adjustment to TPUC on Staff Exhibit 20.0, Schedule 20.02?

A. No. Ms. Hathhorn proposes to exclude AFUDC-generating plant from rate base. Ms. Hathhorn maintains this is necessary because IDC is a below-the-line item and that including CWIP in rate base would result in a double recovery of construction financing costs. The Company, however, has accepted the methodology proposed by Mr. Smith in his original testimony. The principles underlying the Company's acceptance of Mr. Smith's methodology can be found in the proceeding and order of the Federal Communications Commission ("FCC"). See "The Accounting and Ratemaking Treatment for the Allowance for Funds Used During Construction (AFUDC)," Docket No. 93-50, released February 28, 1995. While the Company does not dispute Ms. Hathhorn's contention that AFUDC has been considered a below-the-line item, the methodology promulgated by the FCC eliminated the double recovery concern expressed by Ms. Hathhorn. Specifically, the FCC recognized three ways to compensate carriers for their investments in assets during the period they are being readied for service:

Capitalization Method – Under this method, Telephone Plant Under Construction (TPUC) is excluded from the rate base during the

construction period, but carriers are allowed to capitalize the interest costs, i.e. AFUDC, during the same time period. When plant is placed into service, the cost of construction, including capitalized AFUDC, is transferred from TPUC accounts to plant in service accounts and included in the rate base. Carriers are permitted to earn a return on the investment in the new plant. The cost of the investment is recovered through depreciation charges over the useful life of the plant.

Rate Base Method – Under this method, TPUC is included in the rate base during the construction period, and interest is treated as an expense during the same time period.

Revenue Requirement Offset Method - Under this method, TPUC is included in the rate base during the construction period and AFUDC is recognized as part of that cost of construction. To prevent double recovery, AFUDC for the current period is treated as a revenue amount for ratemaking purposes.

The FCC adopted the revenue requirement offset method on the basis that the method is both consistent with Generally Accepted Accounting Principles (GAAP) and fair and reasonable for ratemaking purposes. The FCC amended the Uniform System of Accounts, CFR Part 32 in its adoption of this method. The FCC discussion concludes at Paragraph 10 of the Order:

the revenue requirement offset method would give the carrier an incentive to invest in new plant because both short- and long-term plant under construction and the capitalized AFUDC would be included in rate base and, as a result, carriers would be allowed to earn a rate of return on the total investment. Moreover, under the revenue requirement offset method the amount of AFUDC capitalized is included both in the rate base and in current income for ratemaking purposes. This has the effect of mitigating the increase in the revenue requirement that results from including all TPUC in the rate base. In sum, because the other methods lack these advantages, we believe that the interstate ratemaking treatment of interest expense during construction under the revenue requirement offset method is superior to the alternatives.

- Q. Has the Company treated the AFUDC as a revenue amount in the current period as required by the revenue requirement offset method in order to avoid double recovery?**
- A. Yes. The adjust AFUDC calculation for the revenue offset is shown in Exhibit 7.2, Schedule 3. The resulting calculation on Schedule 3 is carried forward to Exhibit 7.2, Schedule 1, Column F and is now reflected in Operating Revenue.
- Q. Was the FCC's revenue requirement offset method adopted by this Commission?**
- A. Yes. Section 710.1, Adoption of 47 CFR 32 by Reference, of 83 Illinois Administrative Code, adopted the FCC's USOA as of January 1, 1988 by reference. Since the FCC's methodology results in adjustments to operating income materially the same as that proposed and shown by Ms. Hathhorn, the Company proposes to use the FCC's revenue requirement offset method.
- Q. At page 36 of his rebuttal testimony, GCI witness Smith claims that the 36 month average balance of TPUC should be used rather than the 1999 year-end balance of TPUC "to adjust TPUC to a normalized level." Please comment on Mr. Smith's claim.**
- A. Mr. Smith asserts that this adjustment is necessary due to an abnormally high balance of TPUC at December 31, 1999. I do not agree that a normalization adjustment is appropriate. Furthermore, I have further reviewed the TPUC balance at year end and analyzed the components of the year end balance. This information has been provided in response to data request DLH-066. Based on that review, I have made several adjustments to the year end balance of TPUC and related adjustments to the December 31, 1999 balance of Telephone Plant in Service ("TPIS"). These adjustments are reflected on Schedule 2, Column C of Exhibit 7.2 and are detailed on Exhibit 7.2, Schedule 4.

Q. Please describe your adjustments to the TPUC as shown on Schedule Exhibit 7.2, Schedule 4.

A. I have removed the plug-in circuit board equipment ("PICS") accrual of \$26.8 million from the TPUC balance and added it to the Telephone Plant in Service.

As discussed in the response to data requests DLH-064 and DLH-065, this accrual represents unpaid invoices for plug-in circuit boards at the end of the month, for which Ameritech Illinois has received and taken ownership of the equipment.

The plug-in board are shipped "just in time" from the Ameritech warehouse of central stock in South Bend, Indiana for equipment orders. The invoices are paid in the subsequent month, at which time the accrual is reversed and the equipment is then recorded in Telephone Plant In Service. If it were not for the timing of the invoice payment, all of this equipment would be charged directly to the Telephone Plant In Service accounts which is the proper accounting. The adjustment to reduce the year-end balance of TPUC and the offsetting adjustment to increase TPIS is carried forward from Schedule 4 to Exhibit 7.2, Schedule 2, Column C. As a result of these adjustments, the correctly stated intrastate balance of TPUC is \$39.137 million, an amount less than the 36 month average balance used by Mr. Smith.

Q. Why are these adjustments necessary?

A. These adjustments are needed to properly reflect the Telephone Plant in Service along with the TPUC and the AFUDC balance at December 31, 1999 in accordance with the revenue requirement offset method ordered by the FCC in Docket 93-50.

Q. At pages 7 to 8 of his Rebuttal Testimony, Mr. Smith explains that under the revenue requirement offset method, the adjustment of AFUDC should be consistent with the balance of TPUC reflected in 1999 Statement of Net Original Cost of Property. Do you agree?

A. Yes. As a result of the adjustment to reduce the TPUC balance to \$39.137 million discussed above, the income statement adjustment for AFUDC revenue offset should be \$.245 million, rather than \$2.245 million as reflected in Schedule 1, Column K of Ameritech Illinois Exhibit 7.1. A correcting adjustment for this item is reflected in Schedule 1 of Ameritech Illinois Exhibit 7.2, Column F. Although originally shown as an expense decrease on Exhibit 7.1, Schedule 1, for presentation clarification, the AFUDC revenue offset is now shown as a revenue increase on Exhibit 7.2, Schedule 1.

F. Directory Revenue

Q. Mr. Smith proposes an adjustment for Directory Revenue imputation in the amount \$126 million as shown on GCI Exhibit 6.3, Schedule E-1. As indicated in her surrebuttal testimony, Ms. Everson agrees with this adjustment. Do you agree with this proposed adjustment?

A. No. This adjustment is inappropriate for all the reasons discussed by Mr. Gebhardt and Mr. Barry in their Rebuttal and Surrebuttal Testimonies.

G. Incentive Compensation

Q. Staff witness Everson continues to propose an adjustment to remove incentive compensation from Ameritech Illinois' 1999 level of operating expenses. Do you have any comments on Ms. Everson's testimony in this regard?

A. Yes. As I previously explained, and as Ms. Everson acknowledges, incentive compensation is commonly used by companies as part of their overall compensation levels. As such, incentive compensation is a normal and prudent operating expense, and it would be inappropriate to simply ignore such expense in

reporting the Company's financial performance in 1999. Ms. Everson offers no reasoned basis for her proposed adjustment. If incentive compensation were eliminated, base salaries would need to be increased commensurately in order to attract and retain capable management employees. Accordingly, there is no basis for Ms. Everson's assertion that incentive compensation increases the Company's operating expenses over the level that would exist in the absence of the incentive compensation plan. To the contrary, by providing incentives for cost controls and efficiencies, incentive compensation contributes to reducing expense levels.

Q. Ms. Everson disagrees with your statement that incentive compensation contributes to the attainment of financial targets and therefore benefits customers in that base rates would be lower than they would otherwise be. Please comment on Ms. Everson's testimony in this regard.

A. Ms. Everson's analysis is flawed. Again, Ms. Everson is addressing incentive compensation in isolation and as a singular factor in the Company's achieving its financial targets. Thus, her analysis ignores the fact that the achievement of financial targets is a result of many factors including cost containment initiatives and operational efficiencies. That is why I clarified that incentive compensation *contributes* to the attainment of financial targets. Ms. Everson apparently read my statement as incentive compensation is the sole cause of achieving a Company's financial target, which is not what I was stating.

Q. Ms. Everson maintains that you have overlooked the fact that the proposed adjustments were prepared for the purpose of supplying the Commission with a revenue requirement under a rate of return methodology and that the adjustments were never intended to apply to price cap regulation. Ms. Everson maintains that your comments regarding the applicability for other regulatory methodologies only serves to confuse the issue. Do you have any response?

A. Yes. My comments went to the inapplicability of Ms. Everson's circular reasoning argument, i.e., that incentive compensation leads to an achievement of financial goals which leads to an increase in base rates which leads to increased incentive compensation. Ms. Hathhorn's "circular reasoning" argument is an argument that incentive compensation expense should be disallowed because the level of such expense is influenced by incentives which allegedly rise out of the traditional system of rate base/rate of return regulation. As I explained in my Rebuttal Testimony, Ms. Everson's rationale for including incentive compensation expense does not logically apply in this instance. Since the adoption of the Alternative Regulation Plan in 1994, the Company's rates have not been dependent on its achieving financial goals. Rather, the Company's rates have been dependent on the price cap formula adopted under Alternative Regulation which expressly severed the link between the Company's costs and earnings and the determination of rates. Accordingly, in reviewing the level of earnings in 1999, it is improper to pretend, as Ms. Hathhorn does, that the Company has not been, and will not continue to be, subject to price cap regulation.

Moreover, Ms. Hathhorn's analysis does not recognize other factors that are prerequisites for, and enable the achievement of, financial targets, such as cost controls and improved efficiencies. Incentive compensation positively impacts cost control and operational efficiencies which result in reduced expenses. Moreover, as I indicated in my Rebuttal Testimony, the Commission has allowed recovery of incentive compensation expense in the two most recent proceedings

involving a review of Ameritech Illinois' revenue requirements (Dockets 89-003 and 92-0448/93-0239), as well as several other cases. Thus, even if the Commission were to adopt the fictional premise that the Company's incentive compensation expense has been, and will be, influenced by incentives attributable to traditional rate base/rate of return regulation, there still would be no valid basis for removing incentive compensation from the 1999 level of expenses. Furthermore, the record in the proceeding is clear that Ameritech Illinois' productivity improved during the period the Company was operating under an incentive regulation plan -- to say the incentive compensation did not play a role as Ms. Everson imagines, is incorrect and contrary to logic.

H. Social & Service Clubs

Q. At page 8 of her testimony, Ms. Everson discusses her revised adjustment to eliminate Social and Service Club dues in the amount of \$266,994. Do you agree with her adjustment?

A. No, I do not. As I have pointed out in my Rebuttal Testimony, these are normal and prudent costs of doing business and may not properly be ignored in analyzing the Company's 1999 financial performance. A portion of the costs represent Chamber of Commerce dues. As I have previously explained, such costs help promote both business and development within the community, which in turn benefits customers.

As I also explained, the remaining portion of the costs represent dues paid to various business and industry organizations, primarily the Illinois Telecommunications Association ("ITA"). Ms. Everson argues that ITA dues should be eliminated because membership in ITA provides "opportunities to

participate with other companies to assist in the creation and revision of rules and laws impacting the industry”. She fails to explain how this fact supports her adjustment. The ITA provides a forum for its members to identify and examine issues of importance to the telecommunications industry through numerous committees, including: (i) the accounting and tax committee, which works with the Illinois Department of Revenue on tax laws and their interpretation within the industry; (ii) 9-1-1 Emergency Service committee, which represents the industry before the Commission on 9-1-1 matters and coordinates 9-1-1 provisioning in counties with multiple providers; (iii) a right-of-way committee, which assists in resolving issues involving the complexities of this issue; and (iv) a personnel, labor relations and human resource development committee. The activities of the ITA are appropriate and the Company’s ITA membership dues are a legitimate and prudent cost of doing business.

Q. Do the activities of the ITA constitute “lobbying” as Ms. Hathhorn alleges?

A. No. The FCC has defined lobbying in Part 32 of The Uniform System of

Accounts for Telecommunications Companies, Section 32.7370, as follows:

Lobbying includes expenditures for the purpose of influencing public opinion with respect to the election or appointment of public officials, referenda, legislation, or ordinances (either with respect to the possible adoption of new referenda, legislation or ordinances, or repeal or modification of existing referenda, legislation or ordinances) or approval, modification, or revocation of franchises, or for the purposes of influencing the decisions of public officials. This also includes advertising, gifts, honoraria, and political contributions. This does not include such expenditures which are directly related to communications with and appearances before regulatory or other governmental bodies in connection with the reporting utility’s existing or proposed operations.

The expenses incurred for ITA membership do not fit the FCC definition of lobbying as described above.

I. External Relations Expense

Q. At pages 9 to 11 of her Rebuttal Testimony, Ms. Everson discusses her proposal to eliminate the 1999 level of expenses recorded in Account 6722, External Relations. Do you have any comments in response to Ms. Everson's testimony in this regard?

A. Yes. In support of her proposal, Ms. Everson argues that Account 6722 includes amounts spent for "corporate image building and review of pending legislation." For the reasons discussed in my Rebuttal Testimony, and below in response to Mr. Smith, costs associated with non-product "institutional" or "goodwill" advertising (what Ms. Everson refers to as "corporate image building") are legitimate and reasonable costs of doing business and should not be disregarded. Of the \$20.413 million in intrastate external relations costs, only \$6.807 million represents non-product institutional advertising costs. The remaining portion represents other costs associated with maintaining relations with government regulators, other companies, and the general public. These activities include (a) reviewing existing or pending legislation; (b) preparing and presenting information for regulatory purposes, including tariff and service cost filing; (c) administering relations, including contracts with telecommunications carriers, utilities, and other businesses; and (d) administering investor relations. While these activities do include review of pending, as well as existing, legislation, Ms. Everson fails to offer any rational explanation for disregarding such costs. All of the costs included in Account 6722, including costs of reviewing pending

legislation, are reasonable and necessary costs of doing business as a regulated telecommunications carrier.

Q. In support of her proposed adjustments, Ms. Everson also asserts that the Company failed to provide a breakdown of the costs recorded in Account 6722 by type of activity, as described in the instructions for that account contained in the FCC Part 32 Uniform System of Accounts (“USOA”). Do you have any comments in response to this assertion?

A. Yes. As the Company noted in its response to Staff Data Request MHE-045, it does not track the costs recorded in Account 6722 by each “descriptive activity,” as described in the USOA. Moreover, there is no requirement that the Company track its costs in such a manner. The costs included in Account 6722 consist primarily of salary and benefit expense. As Ms. Everson correctly states, the Company was able to identify the intrastate amount of non-product institutional advertising included in Account 6722 during 1999. This information was readily available because Ameritech Illinois receives a distinct bill for its share of such advertising expense from its parent company, Ameritech. Accordingly, the fact that the Company was able to provide such information does not, contrary to Ms. Everson’s assertion, mean that the cost of each of the other “descriptive activities” could “also be isolated and provided to Staff” (Staff Exhibit 21.0, page 10). Furthermore, because all of the “descriptive activities” are reasonable and necessary for doing business in Illinois, the alleged failure to provide a breakdown of costs by each “descriptive activity” does not logically support Ms. Everson’s proposed adjustment.

Q. At page 5 of her surrebuttal testimony, Ms. Everson points to an apparent discrepancy in which the Company has provided an amount of \$7.610 million representing “institutional and goodwill” advertising costs in rebuttal testimony while the amount of \$6.807 million was provided in response to CUB data request 5.36. Do you have any comments?

A. Yes. I inadvertently used the amount of \$7.610 million in my rebuttal testimony by applying an incorrect jurisdictional factor to the total company amount. The correct intrastate amount is \$6.807 million, which was the amount provided in response to CUB data request 5.36.

Q. Do you have any additional comments regarding Ms. Everson’s testimony on external relations expense?

A. Yes. The Company believes the information which has previously been provided to Staff is sufficient to support the 1999 level of external relations expense. Nonetheless, in response to Ms. Everson’s rebuttal testimony, the Company is providing a breakdown of the amounts recorded in Account 6722 in 1999 by the expense categories maintained by Ameritech Illinois. This expense analysis, which is set forth in Schedule 5 of Ameritech Illinois Exhibit 7.2, shows that of the total company expenses in Account 6722, \$10.373 million (\$6.807 million intrastate) million is institutional and goodwill advertising. The remainder of the account is wages and benefits and affiliated costs from Ameritech Services and Ameritech Corporate, none of which are related to advertising functions.

J. Revised Nonregulated Allocated Factor

Q. At pages 13 to 14 of his Rebuttal Testimony, Mr. Smith takes issue with your revision to the nonregulated factor applied to “prior period” expense adjustment. Do you have any response to Mr. Smith’s testimony in this regard?

A. Yes. As discussed in my rebuttal testimony, a revision to the nonregulated factor from 0.1303 to 0.0463 was necessary because the prior period activities that were adjusted were all booked to account 6728, Other General and Administrative Expense. The application of the 0.1303 factor to these activities was inappropriate since that factor relates to the entire Corporate Operations Expense grouping (all of the 67XX accounts). The factor applicable to Account 6728, Other General and Administrative Expense, is 0.0463. The FCC’s Joint Cost Rules specify that costs are to be allocated based upon a direct analysis of the origin of the cost. (See C.F.R. Section 64.901 Allocation of Costs.) Therefore, the use of a general allocator (as is the case with respect to the 0.1303), which is associated with the Corporate Operations Expense summary of accounts would be inappropriate when a more precise factor (0.0463), which is based upon the actual account (6728) that the transactions were booked to in the Ameritech Illinois general ledger, is available.

Q. On page 8 of his rebuttal testimony Mr. Smith asserts that there was an inconsistent use of the nonregulated factor in the adjustment on Ameritech Illinois Exhibit 7.1, Schedule 1, Column J. Is Mr. Smith correct?

A. Yes. In my Rebuttal Testimony, the Company accepted Mr. Smith’s and Staff witness Hathhorn’s adjustment to remove the \$9.253 million of intrastate operating expenses for merger costs that SBC billed in 2000 prior to updating the nonregulated factor adjustment shown on Ameritech Exhibit 7.1, Schedule 3

(which decreased the nonregulated factor from .1303 to .0463). The use of the proper nonregulated factor (.0463) increases the intrastate adjustment from \$9.253 million (as reflected in the Company's rebuttal income statement shown on Exhibit 7-1, Schedule 1, Column J) to \$10.143 million. A correcting adjustment to the operating income statement is shown on Ameritech Illinois Exhibit 7.2, Schedule 1, Column G.

Q. Mr. Smith asserts that if the Commission determines that the 4.63 percent nonregulated factor is appropriate for merger costs, then the calculation for the other components of the \$117.902 prior period adjustments would need to be similarly adjusted. Those components are the amortization of the IBT pension settlement gain and the amortization of asset disposition accrual amounts. Please comments on this proposal.

A. Since the Company disagrees that either the amortization of pension settlement gains or the amortization of asset disposition accrual credit amounts is appropriate, no further adjustments are necessary.

K. Reciprocal Compensation

Q. Mr. Smith proposes an adjustment to reciprocal compensation expense (GCI Exhibit 6.2, pages 19-22). Do you have any comments on this proposed adjustment?

A. Yes. Mr. Smith proposes to reduce intrastate reciprocal compensation expense by \$33.3 million. His adjustment is based upon the assumption that the amount included for 1999 total company reciprocal compensation expense, as shown in Schedule 1 of Ameritech Illinois Exhibit 7.0, is \$170.8 million. Mr. Smith observes that the annualized level of 2000 reciprocal compensation appears to be \$71 million. Additionally, Mr. Smith observes that there are \$60.7 million of reciprocal compensation expense credits recorded in 2000 for which some portion should apply to 1999. Mr. Smith indicates on GCI Exhibit 6.3, Schedule E-18,

Line 6, that a normalized level of reciprocal compensation expense is \$128.2 million.

Mr. Smith's assumptions regarding reciprocal compensation expense were based on the Company's response to data request CUB-5.30. In that response the Company indicated that the total company reciprocal compensation expense for 1999 was \$170.8 million. In the course of reviewing Mr. Smith's rebuttal testimony, however, I further reviewed the Company information provided to CUB in response to data request CUB 5.30 and determined that the information provided required revision. After the 1999 books were closed, an adjustment was made to reduce \$42.5 million of contingent liability associated with the recording of reciprocal compensation expense. This adjustment was included for reporting to the FCC (ARMIS reports) and the Illinois Commission (Annual Report Form 23). It is these reports that formed the basis of the Ameritech Exhibit 7.0, Schedule 1. Accordingly, although the initial response to CUB 5.30 indicated that the level of reciprocal compensation expense included in Exhibit 7.0, Schedule 1 was \$170.8 million, the actual amount was \$128.3 million (\$170.8m less \$42.5m). As soon as the Company discovered the error in the reported information on the data request, which was after Mr. Smith submitted his rebuttal testimony, we revised the company response and sent a copy and clarifying explanation to CUB and the Staff.

As previously discussed, Mr. Smith's adjustment assumes a normalized level of reciprocal compensation expense of \$128.7 million. Since that is in fact

the level of reciprocal compensation expense that already exists in Ameritech Exhibit 7.0, Schedule 1, no further adjustment is required.

Q. Is Mr. Smith correct in his assertion that some of the \$60.7 million of reciprocal compensation credits recorded in 2000 relate to 1999 activity?

A. Yes, he is correct that some of the credits recorded in 2000 relate to 1999 activity. However, \$40 million of these credits relate to the \$42.5 million liability adjustment, which, was already recognized in the 1999 reporting. Therefore, the actual 2000 reciprocal compensation expenses were \$126.7 million (\$87.1m net booked amount plus \$40m of 1999 accrued credits). This amount is relatively the same as the 1999 expenses of \$128.3 million, which further demonstrates that no additional adjustments are necessary to the 1999 level of reciprocal compensation expense as reported on Ameritech Exhibit 7.0, Schedule 1.

L. Asset Disposition Accruals

Q. At page 30 of his testimony, Mr. Smith continues to recommend a five year amortization of a credit for asset disposition accruals. Do you have any comments with respect to this adjustment?

A. Yes. Mr. Smith's proposal should be rejected for reasons fully discussed on pages 37 and 38 of my Rebuttal Testimony. The transaction which gave rise to the accrual occurred in 1994 and had nothing to do with 1999 operations. Accordingly, the credit to Corporate Operations Expense which was recorded in 1999 to remove the balance of the accrual should be eliminated entirely in order to properly state a normalized level of 1999 Corporate Operations Expense. Mr. Smith's proposed adjustment would improperly give credit for prior period accruals in the results for 1999.

Q. Do you have any additional comments regarding Mr. Smith's proposed adjustment for the asset disposition accrual credit?

A. Yes. Mr. Smith proposes to amortize the intrastate portion of this credit over a five year period. However, the adjustment, as shown on Mr. Smith's Schedule E-5 Revised, reduces expenses by \$2.963 million, thereby reflecting in the 1999 operating income statement a credit amount equal to 4/5, rather than 1/5, of the intrastate credit amount of \$3.704 million. The Company has been informed by GCI that Mr. Smith intends to revise his adjustment to make it consistent with his proposal to amortize the credit over five years.

M. Service Quality Measures

Q. At pages 44 through 46 of his rebuttal testimony, Mr. Smith proposes an adjustment to revenues for year 1999 for the Company's failure to meet service quality standards. Do you have any comments with respect to Mr. Smith's proposal?

A. Yes. For the reasons I indicated in my rebuttal testimony, the proposed adjustment to revenues for 1999 related to the Company's failure to meet service quality standards should be rejected. The proposed adjustment in Mr. Smith's rebuttal testimony differs only in amount from that proposed in his testimony. His testimony proposed an adjustment of \$2.450 million, adjusted for uncollectibles, which represented one-half of the 1998 and 1999 annual amounts of the service quality penalty. His rebuttal testimony proposes an adjustment of \$29.579 million, adjusted for uncollectibles, which represents the cumulative benefit to ratepayers of the reduction in revenues since adoption of the Alternative Regulation Plan in 1994. As I indicated in my rebuttal testimony, customers have already received the benefit of the service quality penalties in the year the penalty

was incurred and in each year thereafter. For example, the \$4 million penalty assessed in 1996 had a cumulative benefit to customers of over \$14 million through 1999. If rates were reinitialized in the manner proposed by Mr. Smith, an annual “penalty” of \$29.579 million would be indefinitely locked into Ameritech Illinois’ rates without regard to the level of service quality. Not only is such an approach arbitrary and unfair, it is inconsistent with the concept of “reinitializing” rates.

N. Non-Product Corporate Brand Advertising

Q. At pages 46-47 of his testimony Mr. Smith continues to recommend an intrastate adjustment of \$6.807 million for non-product specific advertising. Do you have any response to this proposal?

A. Mr. Smith asserts that the purpose of non-product advertising is only image building and that no proof of additional sales of regulated services in Illinois has been offered by the Company to substantiate this expense. While the Company agrees that it is very difficult to accurately measure the results of this type of advertising, to claim that there is no benefit of increased sales is misleading. While the “non-product” or “image” advertising does not focus directly on the promotion of a specific product, it is intended to create positive images of the Company in the mind of consumers, thereby promoting sales of all of the Company’s products and services. For the reasons discussed in my Rebuttal Testimony, the “brand” advertising conducted by Ameritech is an integral part of Ameritech Illinois’ efforts to successfully promote its products and services and to successfully bid on communications solutions for large business and institutional customers. As a result, “brand” advertising helps to generate revenue

and retain traffic on Ameritech Illinois' network. "Brand" advertising is a reasonable and, indeed, necessary cost of doing business and should not be arbitrarily disregarded in an analysis of the Company's 1999 financial performance.

O. Revenue Charges From Additional 2000 Tariff Filings

Q. In accepting the Company's adjustment to revenues for certain tariff filings during 1999, Mr. Smith expresses a concern that the "local service revenue amount reflected by IBT as an inadequate reflection of known and ongoing levels of local service revenue" (GCI Exhibit 6.2, page 16). Is Mr. Smith's concern justified?

A. No. In support of his testimony on this point, Mr. Smith asserts that "growth in local revenue from 1999 to 2000 September year-to-date has been approximately \$200 million." As I discussed in my rebuttal testimony, however, a complete twelve month analysis indicates that there almost no increase in local revenues, as a result of fourth quarter adjustments. As I also discussed in my testimony, any adjustments to 1999 revenue to reflect changes in revenue levels attributed to changes in the 1999 levels of customers and demand would violate test year matching principles. In this regard, all of the Company's adjustments to 1999 operating revenues reflect the annualized effects of known and measurable changes (both increases and decreases) in the rate levels for various services as a result of the 1999 and 2000 price cap filings and the tariff filings during 1999 and 2000. The Company's adjustments do not reflect a change in the level of revenues associated with a change in 1999 levels of expenses and investment. As a result, the level of revenues reflected in the Company's proposed operating statement are properly matched with the 1999 operating expenses and investment.

Mr. Smith does not allege (and there is no evidence to support an allegation) that the Company's revenue adjustments do not accurately reflect price level changes. Accordingly, there is no basis for Mr. Smith's suggestion that those revenue adjustments are inadequate. Finally, I would note that Staff witness Voss, in his direct testimony, proposed an adjustment to 1999 revenues based on arguments similar to those made by Mr. Smith. In his rebuttal testimony, however, Mr. Voss withdrew his proposed adjustment based on a review of my rebuttal testimony and the Company's responses to Staff data requests.

Q. Mr. Dominak, did you compute an overall rate of return on net original cost of property based upon the adjustments made in Exhibit 7.2?

A. Yes, I did. The revisions reflected on Exhibit 7.2 change the overall return for 1999 from 19.13% to 19.21%.

Q. Mr. Dominak, does this conclude your surrebuttal testimony?

A. Yes, it does.